Before the New Mexico Legislature's Revenue Stabilization and Tax Policy Committee

Summary of Remarks on:

Trends in Tax Policy Issues Relevant to New Mexico

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The Federation of Tax Administrators is the Washington, D.C. based membership organization for the tax and revenue agencies of all 50 states, the District of Columbia and the City of New York. The FTA advocates for the interests of state tax administrators and promotes best practices in tax administration and enforcement.

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ISSUES

- **Corporate Income Tax – Market Based Sourcing**
- **Sales Tax (Gross Receipts Tax) –**
  - **Nexus Laws**
  - **Digital Goods**
- **Review of Effectiveness of Tax Incentives**
- **Independent Administrative Hearings**

CORPORATE INCOME TAX – MARKET BASED SOURCING

Background

Multistate businesses can be taxed in multiple states. States may not constitutionally tax 100% of a multistate business's income.[i] States must apportion that income somehow. Most use what is known as "formulary apportionment." (This is in contrast with separate accounting, which is what states including New Mexico used historically, and what the federal government still uses for multinational businesses.)

Formulary apportionment—like the name sounds—uses a formula or a percentage to calculate the amount of a multistate business's income that is taxable in the state. States can and do use different formulas.[ii] (So the apportioned income in all states may not add up to exactly 100%.) The formula must simply be reasonable.

In the 1960s, states tried to come up with a uniform apportionment formula. That formula used the percentages of a business's total property, payroll and sales in the state (averaged together). New Mexico still uses that "three-factor" formula for all non-manufacturing businesses.

EXAMPLE

Total Business Income	**$1 million**	
Apportionment Factor for NM – Standard 3-Factor Formula	**New Mexico**	**Everywhere**
Property	**$100,000**	**$1,000,000**
Percentage	**10%**	
Payroll	**$250,000**	**$1,000,000**
Percentage	**25%**	
Sales	**$500,000**	**$2,000,000**
Percentage	**25%**	
Total Apportionment Factor	**60%**	
Average Apportionment Factor (Total % /3)	**20%**	
Apportioned NM Income	**$200,000**	

"Sourcing" Under the Standard Formula

When an amount of property, payroll or sales is assigned to a particular state for determining the state's apportionment formula—we refer to that as "sourcing" that amount to that state. So in this example, the $100,000 of property is property of the business located in, and therefore "sourced" to New Mexico. The $250,000 of payroll is the compensation for employees primarily working in the state (or based out of the state), and therefore "source" to New Mexico.

The original idea behind the formula was that the inclusion of payroll and property would tend to apportion income to the state(s) where the business conducts its primary activities. The inclusion of sales would tend to apportion income to the state(s) where the business makes a market for its products. Since both kinds of states contribute to the income derived by the business, both have some interest in being able to tax that income.

But when it comes to sales, not all sales end up being sourced to the market state. Rather, there are two different sets of sourcing rules. If the sales are tangible personal property (goods) – then they are sourced to where the customers are.[iii] So in the example above, the $500,000 would represent sales to customers located in New Mexico.

But if the sales are not tangible personal property, but are instead services or intangibles, then a different sourcing rule applies. Rather than sourcing the sales to where the customer is located, the sales are sourced to the single state where the business has its "predominant cost of performance," that is, the state where the business primarily incurs the cost of the income producing activities related to those sales.[iv]

Why does the standard apportionment formula use two different methods to source sales? The drafters of that formula recognized there might be difficulties in determining where a customer "took delivery" of a service or intangible or used that service or intangible. They believed that looking instead to where the business performed the related activities would be easier.

States are Now Moving Toward "Market-Based" Sourcing for All Sales

Over the years, the states became concerned about the problems with "predominant-cost-of-performance" sourcing used for services and intangibles. Two problems in particular concerned the states.

First, because the rule applies to all sales of services and intangibles, there are many instances where it is perfectly possible to determine where the customers of a business are located, but under the rules, the sales will still

be sourced to where the activities are performed. This means that a business with no stores or offices in a state, but with lots of customers, may not pay any income tax at all to that state. (This rule has also been abused by some taxpayers setting up artificial corporate structures.[v])

Second, in other situations, the predominant-cost-of-performance method is actually more complicated to apply. So any benefit from ease of administration is wiped out, and it would make more sense to simply source the sales to the customers' location.

<u>What is the trend?</u>

About half of the states that impose an income tax have now moved to "market-based" (or customer based) sourcing for all sales, including sales of services and intangibles.[vi] The Multistate Tax Commission (which New Mexico is a member of) is working on uniform rules for different situations to help states implement market based sourcing.

NOTE: Market based sourcing does NOT impact manufacturers or most retail businesses, because those business sell goods, not services or intangibles, and so they already source their sales based on where the customer is located. Market based sourcing would impact businesses in the service sectors. Since New Mexico is considered a "market state" (that is, it imports more than it exports) market-based sourcing would tend to apportion more income to the state for tax purposes.

SALES TAX (GROSS RECEIPTS TAX) – NEXUS LAWS

Most lawmakers are aware that for years, the states have had a problem enforcing sales taxes on sales from remote sellers. In 1992, the U.S. Supreme Court in the *Quill* case ruled that mail-order sellers without physical presence in the state could not be made to pay or collect the tax.[vii] Since then, states have been trying to figure out just what *Quill* stands for and also persuade Congress to overturn the decision by enacting federal law.

This committee has had previous presentations on recent legislation introduced in Congress, the Marketplace Fairness Act (MFA),[viii] which proposes to allow states to collect taxes from Internet and other remote sellers if the state adopts certain uniform rules. That legislation has passed the Senate but is unlikely to pass the House of Representatives.[ix]

In recent years, states have also begun to consider how Internet sellers typically do business and whether *Quill*, a mail-order case, would even apply to those sellers.

<u>"Amazon" Laws</u>

Besides the *Quill* case, the U.S. Supreme Court has also considered whether states could impose sales taxes on businesses that had temporary or contract representatives in the state making a market for the seller's goods or services. The Supreme Court has affirmed that this kind of "representative" presence is sufficient to give states jurisdiction (or "nexus") to impose tax.[x]

Several years ago, New York began to look into what the biggest Internet retailers were doing to make a market for themselves in that state. It found that Amazon, Overstock and others had contracted with local organizations—businesses, nonprofit groups, social groups, etc.—that had both a physical presence in the state and a website. Amazon agreed that if these local groups would put a link on their websites to the Amazon website, Amazon would pay a commission for every sale made through that link. (This is also sometimes called "click-through" or "affiliate" nexus.) The theory is that these groups will promote the Internet retailer in order to maximize their commissions.

New York amended its sales tax "doing business" statute (actually, its definition of "vendor") to make clear that the state's position was that such arrangements would subject the Internet seller a sales tax collection duty.[xi] (Neither Amazon nor Overstock were collecting tax on sales into New York at the time.) The Internet sellers challenged that law and lost in the state courts.[xii] The companies have recently been granted an extension to appeal to the U.S. Supreme Court.[xiii]

"Bricks-and-Clicks" Issues

The states have also looked at Internet sellers that are related to entities with retail stores. (In fact, most of the top 50 Internet sellers have such related entities—including several "big box" retailers). Over the years, states have asserted that these "Clicks" (Internet) sellers have nexus to collect and pay tax on the basis of their relationship with their "Bricks" sister-companies.

The New Mexico supreme court recently took up such a case involving Barnes & Noble and its Internet entity, barnesandnoble.com. The court found that the "Bricks" and "Clicks" entities in this case shared both trade names and trademarks as well as marketing and promotional programs, so that the Internet entity should be paying gross receipts tax on sales to its customers in New Mexico.[xiv] (By the time the case got to the N.M. supreme court, barnesandnoble.com was already paying tax.)

Information Reporting Requirements

Not exactly a nexus law, some states are looking at a related type of law that would help them collect tax directly from purchasers. This type of law involves requiring remote sellers to report certain information about sales into the state. Colorado was the first state to adopt a statute that would require Internet sellers to report to the state their sales to customers in Colorado. That law has been challenged in federal court, where the state lost, and the case is now on appeal.[xv] If Colorado should ultimately win that case, and there is a good chance that it will, we are likely to see other states adopting similar laws that would require remote sellers to provide information on their sales but would stop short of requiring them to collect the tax.

What is the trend?

States across the country are taking a hard look at their "doing business" (or "engaging in business" or definition of "retailer") statutes to make sure that they have not inadvertently drafted the language in those

statutes more narrowly than necessary—and to specifically include "Amazon" affiliate provisions or "bricks-and-clicks" provisions, or other examples of activities that the state believes would subject the seller to a sales tax collection and payment duty.[xvi]

Is this necessary? The answer is it depends on existing state law. In some states where the statutory language is broad and general, courts have interpreted that language as "coextensive" with federal constitutional limits. (That is, the courts assume that it is the intent of the legislature to subject to the tax any business that the state would not be prevented from doing so by the federal constitution.) That seems to be the case in New Mexico as well. So maybe general language subjecting sellers to tax is sufficient.

But because business practices change and so does the interpretation of constitutional limits, states may feel like they need to "telegraph" to businesses the state's position with respect to whether certain activities will create nexus. Also, some states have carved out specific activities from their "doing business" statutes, rather than just exempting those activities from tax. This may "muddy the water" by making the "doing business" statute, by definition, narrower than the constitutional limits, and raising questions about whether other activities are included or excluded. New Mexico has carved out of its "doing business" statute two types of activities—having one's websites hosted on a New Mexico server or using a New Mexico (unaffiliated) call center. (See §§ 7-9-4 and 7-9-3.3, which together are New Mexico's "engaging in business" rule for gross receipts tax.)

In New Mexico's last legislative session, a bill was introduced that would add language to the engaging in business statute to make clear that certain activities will create nexus in the state.[xvii] While this may be useful, there is a danger that the state, rather than defining taxable sellers generally, and broadly, will fall into the trap of having to define every kind of activity that might subject a seller to tax. Therefore, care should be used in drafting. Alternatively, the Taxation and Revenue Department may want to issue regulations that would address specific activities.

SALES TAX (GROSS RECEIPTS TAX) – DIGITAL GOODS

Another issue that is getting more attention in the sales tax area is the taxation of digital goods. Because New Mexico's gross receipts tax is much broader than the typical sales tax, the state may already subject some of these types of sales to tax. (Although it may not be possible to collect the tax from remote Internet sellers.) While states are generally prohibited by the federal Internet Tax Freedom Act from imposing tax on Internet access charges and cannot tax digital goods in a "discriminatory" manner under the Act, there is no general prohibition against taxing digital goods. (New Mexico's gross receipts tax was also grandfathered under the Act.)

"Digital goods" are commonly defined as goods that are electronic, rather than strictly physical in nature, and that are delivered electronically over the Internet. Examples include software, iTunes, eBooks, eMagazines, and so-called "streaming" services.

Sellers of digital goods claim that it is difficult if not impossible in many cases for them to know where the customer is when the customer takes "delivery" or makes use of the digital good. States (especially Washington state) have looked at rules for determining where the sale of a digital good should be taxed.

The industry has proposed that Congress adopt federal legislation that would impose uniform sourcing rules for digital goods that may be subject to state sales taxes.[xviii] That legislation has been the focus of significant concern by state and local government groups, including the Federation of Tax Administrators. The bill as introduced in the past would make it very difficult for states to enforce a sales tax on digital goods. Industry has been working with the National Governors Association to fix the legislation. Recently, at the prompting if industry, the National Conference of State Legislatures has endorsed the legislation (generally).[xix] No version has yet been introduced in the current Congress.

What is the trend?

In light of the fact that industry has proposed sourcing rules that they claim will facilitate states imposing sales taxes on digital goods, and the states have begun to consider whether those rules would be useful, now we see a number of states looking at expanding their sales tax imposition statutes to include specific types of digital goods. Especially where digital goods compete directly with traditional products that are already taxable, states are discussing whether it would be good tax policy to tax the digital version of that same product as well.

What does this mean for New Mexico? New Mexico generally taxes "licenses,"[xx] so it may be argued that the state would also tax a number of types of digital goods, which are typically transferred under a type of licensing arrangement. It is not entirely clear whether the state does, in fact, impose gross receipts tax on all digital goods. New Mexico may want to monitor national developments to determine whether any changes need to be made to gross receipts tax statutes or regulations to keep up with taxation of digital goods.

REVIEW OF THE EFFECTIVENESS OF TAX INCENTIVES

Since 2008, most analysts have seen increased focus by state lawmakers on state economic and tax incentives. The goal of lawmakers in tough economic times is to get the biggest "bang for the buck." Determining whether or not an incentive "worked," however, is impossible—at least in any real sense.

Why? Because taxpayers are not granted tax incentives in a "controlled" experimental environment. Consequently, it is not possible to tell for certain if the incentive caused the taxpayer to engage in the activity—or whether it would have occurred anyway—or what would have happened had the incentive been granted to *another* taxpayer instead—or if that same dollar amount had been used for some other purpose, etc.

Consequently, states have come to be somewhat more realistic about measuring the "results" of incentives.

What is the trend?

Despite the fact that it is empirically impossible to answer the ultimate question of whether an incentive "worked," (or what the true return on investment was) states are nevertheless finding that there are good reasons to review the use of incentives. Those reasons include:

- **Avoiding abuse and unintentional or inadvertent inclusion (or exclusion) of taxpayers or activities.**
- **Reviewing reasons why some incentives are more popular than others or whether unused incentives should be eliminated.**
- **Determining if the tax expenditure devoted to the incentive ought to be limited or capped.**
- **Evaluating whether the incentive can be migrated to become part of the "fabric" of the tax itself.**
- **Imposing prospective reporting requirements.**

Avoiding Abuse and Unintentional or Inadvertent Inclusion/Exclusion

It is a common problem with incentives that over time, they can become "leaky" as taxpayers who may not have been the original intended beneficiaries learn to take advantage of the incentive as written.[xxi] This is such a common problem that it is typical for lawmakers to have to come back and "tweak" or narrow the provisions in the years following enactment. It's only slightly less common that lawmakers discover that some taxpayers or activities were inadvertently excluded. Therefore, reviewing incentives for these kinds of issues ought to be routine.

Reviewing Why Incentives Are, or Are Not Popular

It may be that, year after year, some incentives are used by taxpayers and others are not. It's likely that this fact alone can reveal a lot about the usefulness of the incentive in terms of giving a benefit to the targeted taxpayers or activities. It may be that the cost-benefit of some incentives means that only a few taxpayers can take advantage of the incentive. Others may be easier to use, or more visible, or may provide a more direct

benefit. If an incentive is ever going to "work," taxpayers will have to take advantage of that incentive.

Determining If Incentives Should be Limited or Capped

It is becoming much more common for states to impose limits on incentives. There are all kinds, including:

- **Sunset clauses,**
- **Caps on the total state expenditure,**
- **Caps on the total claimed by a single taxpayer,**
- **Time limits generally,**
- **Phase-outs based on size of the taxpayer, level of income, etc.**
- **Claw-backs**
- **Offsets (where only one incentive at a time can apply)**

Migrating the Incentive

Some incentives grow over time to include more taxpayers or activities, generally because lawmakers believe that the incentive should be the rule and not the exception. For example, as states begin to exempt from sales tax different kinds of business inputs, the scope of that exemption has tended to grow—expanding first to equipment, then consumables, etc. Typically, these are broad-based incentives that have some kind of sound policy justification.

Imposing Prospective Reporting Requirements

Beside the fact that it's impossible to conduct a "controlled experiment" with tax incentives so that states can determine what "works," states often don't have information from taxpayers to make any kind of objective analysis of the use of incentives. There has been a trend in recent years to attempt to get more of this information. Those attempts, however, are often limited by the legal protections that taxpayers have guaranteeing the confidentiality of their tax information. While it would be seen my most taxpayers as a breach of that confidentiality for their information to be made public (or given to lawmakers) retroactively, there is no reason why reporting and disclosure of information cannot be made a condition of an incentive on a prospective basis—so long as

taxpayers are aware that there will be an exception to the normal requirement for confidentiality if they request the incentive.

INDEPENDENT ADMINISTRATIVE HEARINGS

A number of groups, including the American Bar Association,[xxii] have urged states to adopt some form of independent administrative process for resolving tax disputes. The issue has long had the support of one of the most prominent business groups focusing on state taxes, the Council on State Taxation, or COST. COST publishes a scorecard ranking states on whether they have an independent administrative process. The last time that scorecard was published, thirty states received either an A or B grade. New Mexico received a D.[xxiii] (Since then a handful of states with low grades have moved to make their administrative hearing process more independent.

Perhaps just as important as independence is proper staffing and resources, not just of the hearing function itself, but of the tax agency. One of the big problems most state tax agencies face is the backlog of cases that are waiting for an administrative hearing. When it takes years to resolve pending protests, this is bad not only for the state, but for the tax agency and the taxpayer.

<u>What is the trend?</u>

States are looking at trying to make their administrative hearing process more independent, to give taxpayers the confidence that they will get a fair hearing. States are also looking to devote the resources necessary to the process to make sure that complicated issues are properly addressed and timely resolved.

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[i] *Northwestern States Portland Cement Co. v. Minnesota*, 358 US 450, 79 S. Ct. 357 (1959).
[ii] *Moorman Mfg. Co. v. Bair*, 437 US 267, 277 n.12, 98 S. Ct. 2340 (1978).
[iii] See, for example, New Mexico's statutory adoption of this rule at NMSA § 7-4-17.
[iv] NMSA § 7-4-18.

[v] See, for example, *Kmart Properties, Inc. v. Taxation and Revenue Department*, 139 N.M. 177, 131 P3d 27 (NMCA 2001).
[vi] Lori Stolly, "News Analysis: The Trend Toward Market-Based Sourcing," State Tax Notes, 69 State Tax Notes 123 (July 15, 2013).
[vii] *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).
[viii] S. 743, currently pending in the House Subcommittee on Regulatory Reform, Commercial and Antitrust Law.
[ix] See Bernie Becker, "Boehner Says He 'Probably' Can't Support Online Sales Tax Bill," The Hill, June 7, 2013.
[x] *Tyler Pipe Industries, Inc. v. Washington Department of Revenue*, 483 U.S. 232 (1987) and *Scripto, Inc. v. Carson*, 362 U.S. 207, 211 (1960).
[xi] N.Y.S. Tax Law § 1101[b][8][vi].
[xii] See *Overstock.com, Inc. v. New York State Department of Taxation and Finance*, 20 NY3d 586 987 NE2d 621, 965 NYS2d 61, 2013 NY Slip Op 02102, 03/28/2013.
[xiii] See *Amazon.com, LLC, et al. v. New York State Department of Taxation and Finance*, U.S. Supreme Court Docket No. 12A1205.
[xiv] New Mexico Taxation and Revenue Department v. Barnesandnoble.Com LLC, Dkt. No. 33,627 (June 3, 2013).
[xv] Order Concerning Cross Motions for Summ. J., *The Direct Marketing Ass'n v. Huber*, 1:10-cv-01546-REB-CBS, 2012 WL 1079175, filed Mar. 30, 2012; Notice of Appeal, *The Direct Marketing Ass'n v. Huber*, filed May 18, 2012.
[xvi] This year alone, legislative proposals have been put forward in a number of states. In 2012, another half-dozen bills were put forward. Since New York first enacted its "Amazon" statute, at least 16 states have acted to reform their doing-business statutes in some form or other, including California, Colorado, Connecticut, Illinois, Iowa, Kansas, Maine, Minnesota, Missouri, Oklahoma, Rhode Island, South Dakota. Texas, Vermont, West Virginia, and Washington.
[xvii] S 539, N.M. Leg. Sess. 2013.
[xviii] See Digital Goods and Services Tax Fairness Act of 2011, H.R. 1860 112th Cong.
[xix] See the NCSL Policy Statement adopted May 31,2013, available at http://www.ncsl.org/state-federal-committees/sccomfc/ncsl-supports-passage-of-the-federal-digital-goods.aspx.
[xx] NMSA §§ 7-9-3.5 and 7-9-3(J).
[xxi] See The Pew Center on the States, "Avoiding Blank Checks, available at http://www.pewstates.org/uploadedFiles/PCS_Assets/2012/Pew_tax_incentives_report.pdf.
[xxii] See the ABA Model State Admin. Tax Tribunal Act (2006), available at http://apps.americanbar.org/tax/groups/salt/ABA1_OFFICIAL_MODEL_ACT_REPORT_AS_ADOPTED_8-7-06.pdf.
[xxiii] See COST 's 2010 Scorecard on State Tax Appeals and Procedural Requirements available at http://www.cost.org/Page.aspx?id=75919.